SUPREME COURT, U. S.

FILED
SEP 1 1961
JAMES R. BROWNING, Clerk

No. 194

In the Supreme Court of the United States

OCTOBER TERM, 1961

PAUL F. MYERS, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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OPINIONS BELOW

The memorandum opinion of the Tax Court (Pet. 15–19) is not officially reported. The order of the court of appeals (Pet. 14) is reported at 287 F. 2d 400.

JURISDICTION

The order of the court of appeals was entered on February 22, 1961 (Pet. 14). The time within which to file a petition for a writ of certiorari was extended to July 3, 1961. The petition was filed on June 30, 1961. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the court below correctly held that the gain realized by petitioners upon a repossession of real

estate under an executory contract for sale is taxable as ordinary income.

STATUTES AND REGULATIONS INVOLVED

The pertinent statutory provisions, Sections 61(a), 1001(c), 1002 and 1222(3), of the Internal Revenue Code of 1954, and the pertinent Treasury Regulations (1954 Code), Sections 1.453–4, 1.453–5 and 1.453–6, appear in the Appendix, *infra*.

STATEMENT

Petitioners in 1952 entered into a contract with F.R.L. Realty Corporation (Realty) for the sale of certain real estate that had been held more than six months, for a consideration of $50,000. The agreement recited that a down payment of $5,000 had already been paid, and the balance was to be payable at the rate of $2,500 per annum, payable semiannually, with interest on the balance. If Realty wished to prepay for a clear title to the property it was to guarantee "earnings" of no less than $10,000. If cash was paid instead of the annual payments, the "total cost" was to be $60,000, at which time Realty was to receive a warranty deed to the property. In addition, Realty agreed, for further security, to build motels on the property costing no less than $30,000, construction to begin within one year from the date of the agreement. Realty also assumed liability for real estate taxes and assessments levied against the property after the date it took possession, as well as for repairs, improvements and insurance (Pet. 16–17, R. 43a, 45a–46a). Realty did not execute a promissory note or any other evidence of

indebtedness other than the contract (R. 40a). The contract contained no provisions for contingencies in case of default (Pet. 17).

After taking possession of the property, with title retained in the petitioners, Realty made payments in 1953 and 1954 that, together with the down payment, totaled $8,750, which was less than petitioners' adjusted cost basis for the property of $12,895 (Pet. 16–17, R. 45a–46a). In 1954 Realty defaulted in its payments. Petitioners agreed to take back the property and terminate the contract. Realty surrendered the premises, and petitioners repossessed the property in December of 1954. During Realty's occupancy no improvements were made to the property (Pet. 17, R. 46a).

The Tax Court held that no sale was ever made by the petitioners; that they merely entered into a contract for sale that was never carried out; and that, to the extent of $8,750 less depreciation, "petitioners realized ordinary income in 1954 when they repossessed the real estate under a mutual agreement with their vendee that the contract of sale was not to be carried out and that they were to retain that part of the purchase price which had already been paid them" (Pet. 18–19). The Court of Appeals affirmed (Pet. 14).

ARGUMENT

The decision below is correct. The admitted gain in 1954 arose not from the contract for sale but from the subsequent agreement under which petitioners regained possession of the property, retained the pay-

ments, and for the first time realized gain.[1] Having been rescinded, the contract for sale was ineffective *ab initio*. *Schuster Electric Co.* v. *H. C. Stores, Inc.*, 61 Ohio App. 331, 335, 22 N.E. 2d 582.[2] Hence, there was no "sale or exchange," which is essential to the applicability of the pertinent capital gains provision of the Internal Revenue Code, Section 1222(3) (Appendix, *infra*); *Helvering* v. *William Flaccus Oak Leather Co.*, 313 U.S. 247. On the contrary, the payments retained amounted in effect to liquidated damages for breach of contract, taxable as ordinary income. *Commissioner* v. *Glenshaw Glass Co.*, 348 U.S. 426; *Johnson* v. *Commissioner*, 32 B.T.A. 156. The only prior decision involving the question here is in accord with the decision below. *Boatman* v. *Commissioner*, 32 T.C. 1188.

There is no merit to petitioners' contention that the decision below conflicts with *Arrowsmith* v. *Commissioner*, 344 U.S. 6. There, the gain from a liquidating dividend when received had been taxed under the capital gains provisions and when, in a later year, it was determined that a portion of the dividend must be returned, it was held that the loss resulting must be treated as a capital loss in the later year. Here, the payments, though they would later have been

[1] As the payments did not exceed petitioners' cost basis, they were not income under any hypothesis when received. *Burnet* v. *Logan*, 283 U.S. 404; *Commissioner* v. *Kann's Estate*, 174 F. 2d 357 (C.A. 3d).

[2] It is to be noted that under state law the 1952 agreement was merely an executory contract for sale, *Coggshall* v. *Marine Bank Co.*, 63 Ohio St. 88, 57 N.E. 1086; *Butcher* v. *Kagey Lumber Co.*, 164 Ohio St. 85, 128 N.E. 2d 54.

considered capital payments had the sale been consummated, did not give rise to any gain when received. It was not until 1954, when the property was repossessed and by mutual agreement petitioners retained the payments, that the payments became income—income that was taxable at ordinary rates.

Petitioners' case is not advanced by their reference to the Treasury Regulations (Pet. 11). The Regulations under the 1954 Code, Section 1.453–6(b) (Appendix, *infra*), which are equivalent to those cited by petitioners,[3] do not apply. They are applicable only to deferred-payment sales under "agreements of purchase and sale" when the title is retained (or to sales in which there is an immediate transfer of title protected by a mortgage or other lien as to deferred payments), Section 1.453–4(a) (1) and (2)[4] (Appendix, *infra*), and then only where the payments received during the taxable year in which the sale is made exceed 30 percent of the selling price, Section 1.453–4(b)(2)[5] (Appendix, *infra*).

CONCLUSION

There is no conflict of decisions, no question of general importance, and no other reason war-

[3] Petitioners cite Section 39.44–4(b) of Regulations 118; however, since the repossession took place in 1954, regulations under the 1954 Code are effective. The latter are substantially the same as those cited by petitioners.

[4] Substantially the same as Section 39.44–2(a) (1) and (2) of Regulations 118.

[5] Substantially the same as Section 39.44–2(b)(2) of Regulations 118.

ranting further review of this case. The petition for a writ of certiorari should be denied.

Respectfully submitted.

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SEPTEMBER 1961.

APPENDIX

Internal Revenue Code of 1954:

SEC. 61. GROSS INCOME DEFINED.

(a) *General Definition.*—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

* * * * *

(3) Gains derived from dealings in property;

* * * * *

(26 U.S.C. 1958 ed., Sec. 61.)

SEC. 1001. DETERMINATION OF AMOUNT OF AND RECOGNITION OF GAIN OR LOSS.

* * * * *

(c) *Recognition of Gain or Loss.*—In the case of a sale or exchange of property, the extent to which the gain or loss determined under this section shall be recognized for purposes of this subtitle shall be determined under section 1002.

* * * * *

(26 U.S.C. 1958 ed., Sec. 1001.)

SEC. 1002. RECOGNITION OF GAIN OR LOSS.

Except as otherwise provided in this subtitle, on the sale or exchange of property the entire amount of the gain or loss, determined under section 1001, shall be recognized.

(26 U.S.C. 1958 ed., Sec. 1002.)

SEC. 1222. OTHER TERMS RELATING TO CAPITAL GAINS OR LOSSES.

For purposes of this subtitle—

* * * * *

(3) *Long-term capital gain.*—The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing gross income.

* * * * *

(26 U.S.C. 1958 ed., Sec. 1222.)

Treasury Regulations on Accounting Periods and Methods of Accounting (1954 Code):

* * * * *

SEC. 1.453–4 SALE OF REAL PROPERTY INVOLVING DEFERRED PERIODIC PAYMENTS.—(a) *In general.*—Sales of real property involving deferred payments include (1) agreements of purchase and sale which contemplate that a conveyance is not to be made at the outset, but only after all or a substantial portion of the selling price has been paid, and (2) sales in which there is an immediate transfer of title, the vendor being protected by a mortgage or other lien as to deferred payments.

(b) *Classes of sales.*—Such sales, under either paragraph (a) (1) or (2) of this section, fall into two classes when considered with respect to the terms of sale, as follows:

(1) Sales of real property which may be accounted for on the installment method, that is, sales of real property in which (i) there are no payments during the taxable year of the sale or (ii) the payments in such taxable year (exclusive of evidences of indebtedness

of the purchaser) do not exceed 30 percent of the selling price, or

(2) Deferred-payment sales of real property in which the payments received in cash or property other than evidences of indebtedness of the purchaser during the taxable year in which the sale is made exceed 30 percent of the selling price.

* * * * *

SEC. 1.453–5 SALE OF REAL PROPERTY TREATED ON INSTALLMENT METHOD.—(a) *In general.*—In any transaction described in paragraph (b)(1) of § 1.453–4, that is, sales of real property in which there are no payments during the year of sale or the payments in that year do not exceed 30 percent of the selling price, the vendor may return as income from each such transaction in any taxable year that proportion of the installment payments actually received in that year which the gross profit (as described in paragraph (b) of § 1.453–1) realized or to be realized when the property is paid for bears to the total contract price. In any case, the sale of each lot or parcel of a subdivided tract must be treated as a separate transaction and gain or loss computed accordingly. (See paragraph (a) of § 1.61–6.)

(b) *Defaults and repossessions.*—If the purchaser of real property on the installment plan defaults in any of his payments, and the vendor returning income on the installment method reacquires the property sold, whether title thereto had been retained by the vendor or transferred to the purchaser, gain or loss for the year in which the reacquisition occurs is

to be computed upon any installment obligations of the purchaser which are satisfied or discharged upon the reacquisition or are applied by the vendor to the purchase or bid price of the property. Such gain or loss is to be measured by the difference between the fair market value at the date of reacquisition of the property reacquired (including the fair market value of any fixed improvements placed on the property by the purchaser) and the basis in the hands of the vendor of the obligations of the purchaser which are so satisfied, discharged, or applied, with proper adjustment for any other amounts realized or costs incurred in connection with the reacquisition. The basis in the hands of the vendor of the obligations of the purchaser satisfied, discharged, or applied upon the reacquisition of the property will be the excess of the face value of such obligations over an amount equal to the income which would be returnable were the obligations paid in full. For definition of the basis of an installment obligation, see section 453(d)(2) and paragraph (b)(2) of § 1.453–9. No deduction for a bad debt shall in any case be taken on account of any portion of the obligations of the purchaser which are treated by the vendor as not having been satisfied, discharged, or applied upon the reacquisition of the property, unless it is clearly shown that after the property was reacquired the purchaser remained liable for such portion; and in no event shall the amount of the deduction exceed the basis in the hands of the vendor of the portion of the obligations with respect to which the purchaser remained liable after the

reacquisition. (See section 166 and the regulations thereunder.) If the property reacquired is bid in by the vendor at a foreclosure sale, the fair market value of the property shall be presumed to be the purchase or bid price thereof in the absence of clear and convincing proof to the contrary. If the property reacquired is subsequently sold, the basis for determining gain or loss is the fair market value of the property at the date of reacquisition (including the fair market value of any fixed improvements placed on the property by the purchaser).

SEC. 1.453–6 DEFERRED-PAYMENT SALE OF REAL PROPERTY NOT ON INSTALLMENT METHOD.—(a) *Value of obligations.*—(1) In transactions included in paragraph (b)(2) of § 1.453–4, that is, sales of real property involving deferred payments in which the payments received during the year of sale exceed 30 percent of the selling price, the obligations of the purchaser received by the vendor are to be considered as an amount realized to the extent of their fair market value in ascertaining the profit or loss from the transaction. Such obligations, however, are not considered in determining whether the payments during the year of sale exceed 30 percent of the selling price.

(2) If the obligations received by the vendor have no fair market value, the payments in cash or other property having a fair market value shall be applied against and reduce the basis of the property sold and, if in excess of such basis, shall be taxable to the extent of the excess. Gain or loss is realized when the obli-

gations are disposed of or satisfied, the amount thereof being the difference between the reduced basis as provided in the preceding sentence and the amount realized therefor. Only in rare and extraordinary cases does property have no fair market value.

(b) *Title retained by vendor.*—(1) if the vendor in sales referred to in paragraph (a) of this section has retained title to the property and the purchaser defaults in any of his payments, and the vendor repossesses the property, the difference between (i) the entire amount of the payments actually received on the contract and retained by the vendor plus the fair market value at the time of repossession of fixed improvements placed on the property by the purchaser and (ii) the sum of the profits previously returned as income in connection therewith and an amount representing what would have been a proper adjustment for exhaustion, wear and tear, obsolescence, amortization, and depletion of the property during the period the property was in the hands of the purchaser had the sale not been made, will constitute gain or loss, as the case may be, to the vendor for the year in which the property is repossessed.

(2) The basis of the property described in subparagraph (1) of this paragraph in the hands of the vendor will be the original basis at the time of the sale plus the fair market value at the time of repossession of fixed improvements placed on the property by the purchaser, except as provided in subparagraph (3) of this paragraph.

* * * * *

U. S. GOVERNMENT PRINTING OFFICE 1961